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Macroeconomic policy questions: financing of development, including net transfer of resources between developing and developed countries

The financial crisis and its impact on growth and development, especially in the developing countries

Report of the Secretary-General

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I. Introduction

1. The present report is submitted in response to General Assembly resolution 53/172 of 15 December 1998 and draws upon the cooperative efforts of various components of the United Nations Secretariat. It has also benefited from ongoing cooperation with the Bretton Woods institutions. In addition, at the initiative of the Government of Mexico and the secretariats of the Latin American Economic System and the Economic Commission for Latin America and the Caribbean (ECLAC), a regional meeting was held from 5 to 7 September 1999 in Mexico City, which also reviewed the issues addressed in this report.[1]

2. Section II of the report contains an analysis of the current trend in global financial flows, while section III examines the main actions taken on issues addressed in General Assembly resolution 53/172. Section IV proposes additional measures for consideration by the international community.

II. Recent financial flows and net transfers[2]

3. The 1990s have seen large shifts in the net transfer of financial resources. The decade began with a rapidly increasing flow into the developing countries which peaked at $63 billion in 1993. This was followed by transfer from these countries that grew to almost $60 billion in 1998 (see table). This shift in aggregate transfers embodied unusual flows first into and then out of a group of Asian countries that, until the mid-1990s, had not made large net drawings of foreign financing.

4. Sometimes, a negative transfer is a sign of economic strength, reflecting strong export success and the accumulation of foreign exchange earnings that exceed imports. In 1998, however, the negative transfer was an indicator of economic weakness, reflecting, in particular, the sharp economic contractions in East Asia. The crisis that accompanied this outflow changed the way policy makers viewed easily reversible surges of financial inflows and raised the saliency of the earlier experiences of a number of Latin American countries.[3]

5. Most of the swing in financial flows in 1998 was accounted for by changes in private foreign lending, particularly short-term lending. The shift was concentrated in Asia, although flows to Latin America were greatly curtailed by the end of the year. Oil exporting countries that hold large stocks of assets and China, which has large official reserves, were best able to continue to draw upon international credit.[4]

6. The large changes in the financial transfers of Latin America in 1998 (which continued into 1999) were the result of international financial contagion. There continued to be large financial flows into Latin America for much of 1998, but there was also increasing uncertainty in the international financial community about some Latin American economies, especially after the Russian crisis broke. In response, the monetary authorities in several of these countries increased domestic interest rates. However, when there is a large amount of short-term public debt and/or longer-term debt on which interest rates are periodically adjusted, monetary tightening will have strong negative consequences for the budget. This can worsen instead of strengthen the sentiment of financial investors, as was the case, for example, in Brazil, whose currency was devalued after strong net capital outflows in the beginning of 1999.[5] By September 1999, the focus of concern among international investors had shifted to Ecuador, where the Government was forced to postpone payments on the previously sacrosanct "Brady bonds", the internationally supported mechanism used by several countries to emerge from the 1980s debt crisis. Overall, net inflows of private capital to Latin America will be lower in 1999 than in 1998, principally owing to the fall-off in

Net transfer of financial resources of groups of developing countries, 1988-1998[a]

(Billions of dollars)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998[b]
All developing countries	-14.8	-21.3	-42.2	28.6	40.4	63.0	29.0	31.3	8.6	-10.8	-59.5
Africa	3.9	0.6	-10.3	-5.8	0.9	2.9	7.6	10.5	-1.1	6.3	19.0
of which:											
Sub-Saharan Africa[c]	7.8	5.9	8.5	9.2	11.4	9.9	8.1	7.6	8.0	10.2	14.0
Latin America and the Caribbean	-22.0	-27.7	-27.6	-9.1	7.8	14.3	16.9	-1.0	-1.5	23.1	45.5
West Asia	23.8	16.7	13.9	50.8	39.4	38.9	9.7	10.4	-0.7	4.6	35.5
Other Asia	-20.5	-12.5	-10.4	-9.4	-5.7	6.9	-5.2	11.5	12.0	-44.7	-159.5
of which:											
China	3.9	4.9	-10.8	-11.8	-5.2	11.4	-8.0	-12.3	-19.2	-44.9	-47.5
Other South and East Asia	-24.4	-17.2	1.0	2.7	-0.6	-4.4	3.6	24.4	31.2	0.2	-112.0
Memorandum item:											
Least developed countries[d]	8.8	8.4	8.7	9.8	11.6	11.6	9.2	11.0	11.2	12.2	16.0

Source: World Economic and Social Survey, 1999 (United Nations publication, Sales No. E.99.II.C.1), table II.1.

[a] Expenditure basis (negative of balance of payments on goods, services and private transfers, excluding investment income).

[b] Preliminary estimate.

[c] Excluding Nigeria and South Africa.

[d] Covering 42 out of 48 least developed countries.

portfolio investment. With imports reduced by the weakness in output growth, this will result in a decline in the region's net financial transfer.

7. The interest costs faced by developing and transition economies that are able to borrow on international markets have remained generally high since the Russian crisis of August 1998. Yields on bonds issued by Asian countries receded below 1998 levels in 1999 but even by September 1999, the yields on bonds of Latin American and other countries had not recovered from the "Russian shock" (see figure I).

Figure I. Yield spreads on emerging market bonds, 31 December 1997 to 9 September 1999

Source: Data of J. P. Morgan and Company, New York.

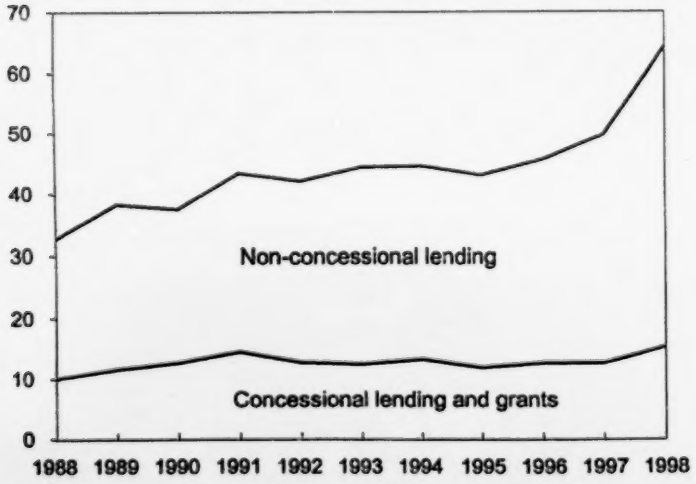
8. The pace of foreign direct investment (FDI) eased only slightly in 1998. FDI into the developing countries fell 4 per cent in 1998, to a level of $165 billion.[6] This was mainly the result of lower foreign investment in South and East Asian countries; in particular, intraregional FDI by companies from within the region is estimated to have dropped by 25 per cent. At the same time, a number of transnational corporations based in Europe and North America have been restructuring their Asian operations and have purchased corporate assets in some of these countries, taking advantage of lower prices for corporate assets and

favourable exchange rates. FDI in the economies in transition as a group was stable overall in 1998, although flows to the Russian Federation fell by half.

9. Flows of official financing rose in 1998, reflecting large commitments to crisis-affected countries both in 1998 and in preceding years. In 1998 alone, the International Monetary Fund (IMF) committed almost $30 billion to developing countries and $3 billion to economies in transition for disbursement over a number of years. Most of the emergency official financing was arranged for middle-income countries on near-commercial terms. Commitments by multilateral development institutions to developing and transition countries jumped $13 billion, to $62 billion, in 1998.[7]

10. Commitments of concessional funds also rose in 1998, in part to address crisis situations. This notwithstanding, concessional multilateral development commitments have been largely stagnant in recent years when measured in dollars of constant purchasing power; this contrasts with the growth of non-concessional financing (see figure II). Bilateral concessional flows have also been relatively stagnant. Official development assistance (ODA) flows to developing countries and multilateral institutions from the member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) declined by 21 per cent in real terms over five years in the 1990s, finally turning upward in 1998.[8] The gain, almost 9 per cent measured in constant prices and exchange rates, reflected in part the response to the "Asian crisis". However, it also reflected previously agreed commitments to multilateral agencies and new commitments to raise ODA, as in the pledge by the United Kingdom of Great Britain and Northern Ireland to have increased its assistance by 25 per cent by 2001. On the other hand, some countries continue to cut back their aid appropriations, with the result that the problem of reinvigorating ODA flows across the board remains to be solved.

Figure II. Multilateral development commitments, 1988-1998
(Billions of 1990 dollars)



Source: **Department of Economic and Social Affairs of the United Nations Secretariat, based on information supplied by individual institutions.**

11. Despite the overall decline in ODA, there has been a relatively steady net inward transfer of financial resources to low-income countries in the 1990s, in particular to the least developed countries (see table). However, resource transfers to these and other low-income countries remain inadequate, and are neither steady nor assured.

12. Moreover, the net transfer includes some inflows that flow out again as debt-servicing payments, leaving no net gain in terms of imports or investment. If the debt-servicing burden of aid-dependent countries was reduced, the same level of official inflows would result in a larger net financial transfer. This is one reason that considerable importance is attached to the success of recent international initiatives, such as that to strengthen the debt-relief programme for the heavily indebted poor countries (HIPC).[9]

III. Progress in strengthening global financial arrangements

13. The General Assembly has called for a range of actions by national and international policy makers in response to the international financial volatility of 1997-1998. Subsequent actions at various levels have addressed many of the issues dealt with in Assembly resolution 53/172 and analysed in the previous section and have involved improvements in existing arrangements and a rethinking of the policies required to prevent crises and to respond to crises. Some international reforms that might previously have been considered beyond agreement have now been accepted, while others, as has been indicated, remain under discussion. The present section reviews recent developments.

A. The international economic and financial environment

14. Just as it may play a critical role in the eruption of a national financial crisis, the international economic environment is also a central determinant of the contagion that may follow a crisis and can be instrumental in the recovery process. The risks of crisis, contagion and slow recovery are reduced in a world economy experiencing substantial and sustained growth, low inflation and a measure of calm in international currency markets. These are more likely to occur when macroeconomic policies are coordinated, particularly the policies of the major industrialized countries which have significant influence over the growth of the world economy and thus over world trade and financial flows.

15. The Group of Seven major industrialized countries (G-7) is an ad hoc mechanism that has on occasion since the 1970s sought to coordinate the macroeconomic policies of members of the Group. The G-7 Finance Ministers and Central Bank Governors meet periodically and the G-7 leaders meet annually. In addition, the central banks of the major currency countries are in close and regular contact and occasionally engage in coordinated intervention in currency markets to smooth exchange-rate movements. Over the years, the G-7 have developed informal channels for exchanges of views and thus for a shared appreciation of the evolving world economic and monetary situation and their respective policy constraints.

16. In the most recent crisis, for example, it was understood by those concerned that the reduction in short-term interest rates by the United States Federal Reserve in the fourth quarter of 1998 would have (and it did have) two effects. First, it would ease the liquidity crisis in United States financial markets. Second, it would facilitate similar action by the other major central banks, reinforcing the initial liquidity stimulus by the United States. The world economy began to respond to these actions in 1999.

17. The contributions of G-7 policies to the global situation are discussed both by IMF staff and by representatives of other countries in IMF during regular Fund discussions of the world economic outlook. In addition, the macroeconomic policies of individual G-7 countries are subject to the same IMF surveillance as all other member countries. During these surveillance exercises, the Fund expresses its views on countries' policies from the perspective of the world economy as a whole. However, the G-7 are under less pressure to respond to IMF policy recommendations than developing and transition economies.

B. Strengthening the financial sector in developing and transition economies

18. With hindsight, it is clear that regulation of the banking sector in the countries hit by financial crises in 1997 had not kept pace with financial liberalization and increased competition. Coupled with explicit or implicit government financial "safety nets" that were established to prevent runs on individual banks from spreading chaos through the financial system, "perverse incentives" were created which encouraged banks to take on excessively risky exposures.[10] The result was a string of bank failures. Since that time, there has been a major effort in several countries to close or consolidate such failed banks, to open the banking sector to more foreign participation (bringing new technology and management practices, as well as capital), to strengthen banking regulations and to enhance the capacity of supervisory agencies to enforce them.

C. Improving information flows

19. It is argued that increasing the amount of publicly available information about countries should both improve the decision-making of international investors and serve as a source of early warning of impending crises. National and international authorities have taken various measures since the crises to improve the availability and international comparability of such information, notably, strengthening the Special Data Dissemination Standard (SDDS). As of 1 September 1999, 47 countries subscribed to SDDS.

20. Cooperation has also intensified among IMF, the World Bank, OECD and the Bank for International Settlements in the collection and publication of external debt statistics of developing and transition economies. In March 1999, the first joint set of quarterly debt data was released. Combining data from creditor and borrower authorities, it will assist policy makers, as well as financial markets, in monitoring the external financial situation in these countries.

21. The confidence of international financial markets and early warning can also be improved by credible assessments of the overall economic situation in individual countries. One such source of information is the "Article IV consultations", which are mandated by IMF's Articles of Agreement and usually undertaken annually. There are two steps in the Article IV process: first, IMF staff visit the country and prepare a report; it is then discussed by the IMF Executive Board and the Chair's summary of those discussions is sent to the Government. Previously, both steps were confidential and this facilitated frank assessments of national economies.

22. Under a new policy begun two years ago and expanded in March 1999, IMF adopted a more systematic approach for the release of "Public Information Notices", which are summaries of the Article IV discussions in the Executive Board, and began to publish the

staff reports on a pilot basis (until 4 October 2000).[11] All such public releases are subject to the member country's permission. This increased transparency is widely applauded, although some observers feel that IMF's role as a confidential adviser to Governments is being eroded and its former scope for frankness may be compromised by the fear of a negative reaction from financial markets following the publication of such material.

23. In a related development, the international community is in the process of developing a number of additional "codes of good practices". SDDS falls into this category but other codes that focus on transparency will also, *inter alia*, contribute to improvements in the availability of internationally comparable information in the economic and financial area. The Interim Committee adopted a Code of Good Practices on Fiscal Transparency[12] in April 1998 and a Code of Good Practices on Transparency in Monetary and Financial Policies in September 1999. Many developing and transition countries lack the capacity to adopt these codes at present and are likely to require international assistance to remedy the situation. Moreover, the codes are intended to serve as broad guidelines which will have to be adapted to the circumstances of individual countries. Adherence to them should therefore remain voluntary and should not be a condition of international support.

24. Since most of the difficulties in international financial markets involve the private sector, these entities also need to contribute to the improvement of information flows. Attention has also been given by both policy makers and the business community to improved transparency, reliability and timeliness of information about companies.

D. Improving standards and regulations

25. In 1988, the Group of Ten (G-10) industrialized countries agreed to common capital adequacy standards for their internationally active commercial banks. The G-10 sought both to reduce the risk that a bank failure in any one of their countries might spread a banking crisis across national frontiers and to prevent less stringent regulations in any one country from giving its banks a competitive advantage in global markets. The initial "Basle Accord" has been supplemented by other similar instruments negotiated in committees that are supported by the Bank for International Settlements.[13]

26. The Basle Accord became the regulatory benchmark of the 1990s for the banking sector and was applied in many countries beyond those that prepared it, even though the banking environment elsewhere may have differed substantially from that in the standard-setting group of countries. Even with regard to their own countries, the regulators had difficulty keeping pace with the rapidly changing and increasingly globalized financial industry. The financial crisis that erupted in 1997 increased the pressure to update and broaden these various international regulatory standards.

27. In January 1999, the Basle Committee on Banking Supervision issued a report analysing banks' interactions with heavily leveraged institutions (HLIs) — first of all, hedge funds — together with guidance on sound practice in such dealings. The Basle Committee (in June 1999) issued a proposal for a new capital-adequacy framework, comments on which are to be gathered until March 2000. In late July 1999, the Basle Committee issued four papers providing guidance to banks and banking supervisors on various aspects of credit risk in banking activities.

28. In addition to the activity on specific regulatory questions, in February 1999 the G-7 established the Financial Stability Forum, with the aim of integrating and strengthening the array of regulatory and related endeavours. The Forum initially comprised representatives of the G-7, the major international regulatory bodies and the main multilateral institutions

responsible for international finance; by September 1999, Australia, Hong Kong Special Administrative Region (SAR) of China, the Netherlands and Singapore had been added. The purpose of the Forum is to identify international financial vulnerabilities and monitor actions to overcome them. The Forum reports to the G-7. At its first meeting in April 1999, the Forum created three working groups which were to report in September 1999 on actions to reduce the destabilizing potential of HLIs; on measures to reduce the volatility of capital flows and risks to financial systems of excessive short-term indebtedness; and on the impact on global financial stability of offshore financial centres and compliance by such centres with international prudential standards and cross-border information exchange agreements.[14]

E. Coping with the volatility of international financial markets

29. Additional information and improved surveillance should reduce, but will not eliminate, the potential for volatility in international financial markets. Similarly, properly regulated and managed financial institutions should be less vulnerable to crisis, but they will not be immune: financial markets will remain subject to "herd" behaviour, pro-cyclical changes in liquidity in derivatives markets, portfolio adjustments and other similarly destabilizing effects.[15] National policy makers thus require additional means to counter and cope with the effects of international financial volatility.

30. It can be argued that countries raised their vulnerability to volatility and contagion by relaxing during the past decade controls on international capital flows, including short-term credit flows. Even before the recent spate of financial crises, recommendations to speed the liberalization of capital flows in developing and transition economies were controversial. In the light of recent experience, advocates of liberalization have made their case more nuanced. In particular, in the October 1998 meeting of the Interim Committee, it was emphasized that capital-account liberalization should be followed in "an orderly, gradual and well-sequenced manner". In addition, the IMF Executive Board was asked to review country experiences with exchange controls. At its meetings in April and September 1999, the Interim Committee encouraged IMF to continue to work on the appropriate pace and sequencing of capital-account opening and to examine individual countries' use and liberalization of capital controls, paying particular attention to the relationship between capital-account liberalization and financial sector stability.

31. A further way to prevent financial crises and their spread is to strengthen the external financial resources for pre-emptive action at the disposal of countries. In addition to the accumulation of a large stock of official reserves by the central bank, there have been negotiations by some Governments of contingent credit lines with foreign private creditors. However, these have limitations.

32. At the international level IMF's Contingent Credit Lines (CCL) was introduced in April 1999 on an experimental basis. Only countries that have been previously assessed by IMF as having strong economic policies are eligible for a CCL. In the event of a crisis, a country having a CCL can seek Board approval of a request to activate the credit line. Approval is to be expeditious and the Board also decides how much of the funds to release immediately and in subsequent tranches. To discourage use of the facility for non-emergency purposes, drawings incur interest rates that are initially 3 percentage points above standard IMF lending rates and that rise over time to a 5 percentage point surcharge. As of September 1999, no CCLs had been agreed.

F. Availability of emergency external financing

33. If preventive measures fail to stave off a financial crisis, a country is likely to need official financial support to ride it out. In late 1998, IMF's usable resources had fallen perilously low and there was widespread concern that its financial capacity to play a credible role in any further crises would be compromised. Matters have improved since. First, the New Arrangements to Borrow (NAB) went into effect in November 1998. NAB is a commitment of 25 member Governments and official institutions to lend IMF up to about $23 billion. Together with the earlier General Arrangements to Borrow (GAB), this provides IMF with access to about $46 billion in credits beyond its own resources for use in emergency operations. Drawings from both credit facilities were made in 1998: GAB was used to help support the adjustment programme of the Russian Federation in July and NAB was utilized in December to help fund the programme of Brazil.

34. IMF was able to repay both these loans by 30 April 1999, as the Eleventh General Review of Quotas took effect in January 1999. When all members have completed payment of their new quotas, the latest increase will raise the IMF's total resources to about $290 billion (not all of which is readily usable).

35. The financing mobilized to combat the recent spate of financial crises required the participation of not only IMF, but also the World Bank, regional development banks and national authorities. The bulk of the funds provided did not benefit the people of the crisis countries but, to a significant degree, financed the disengagement of foreign private creditors and even facilitated capital flight. The support for official financial rescue packages was weakened because of a widespread view that private creditors, both foreign and domestic, were being "bailed out" with public funds. This has caused the international community to seek modalities by which foreign private creditors would participate more fully in resolving emergencies (that is to say, be "bailed in"), for example, by rolling over their maturing credits. One of the challenges in "bailing in" the private sector is to minimize the degree to which the method chosen discourages private capital flows to developing and transition economies, or raises their cost.

36. Progress in encouraging creditors to participate in rescue packages was achieved by the Interim Committee of IMF in October 1998 when it, *inter alia*, endorsed its 1989 policy of "lending into arrears" and announced that it would be willing to consider using this policy on a case-by-case basis. In June 1999, the Executive Board of IMF specified more precisely that lending into arrears might be pursued when immediate IMF support was essential for implementation of the country's adjustment programme, appropriate policies were being pursued and the Government was making a good-faith effort to reach agreement with creditors.

37. Under usual circumstances, IMF expects heavily indebted countries with which it is arranging financial support to work towards agreement with their foreign creditors on their debt-servicing obligations. This assumes a cooperative approach, with short-term arrangements to carry a country until a longer-term agreement is reached. In such cases, arrears do not accumulate. IMF decided, in effect, that it could break with this standard practice and lend to the Government if it determined that arrears were being incurred because private creditors were not cooperating.

38. Lending into arrears does not by itself solve the problem of bailing in private creditors during rescue operations. Informal pressure on creditor banks from their home regulatory authorities has been, and will continue to be, important when it is necessary to accelerate an agreement between foreign banks and debtor countries. This is more easily arranged for large debtor countries than for small ones.

39. Moreover, much international lending today takes the form of securities rather than bank loans and it is difficult to bring security owners together voluntarily for debt-relief purposes. Nevertheless, with bonds accounting for a large fraction of international private financing and with official rescue packages being limited in size, bondholders need to be included in financial rescue arrangements. The summit meeting of the G-7 in June 1999 in Cologne addressed this problem as part of a framework for promoting private sector involvement in crisis resolution. The central feature will be to encourage the introduction of "collective action clauses" into bond contracts; these would specify conditions by which bondholders could reach agreement on restructuring bond debt. Such clauses already exist in "British-style" bonds, but not in the more common "American-style" bonds.[16] Indeed, one reason for the popularity with investors of American-style bonds is that they are difficult to restructure and this makes borrowers very reluctant to stop servicing them. By the same token, the introduction of collective action clauses may cause borrowing costs to rise if purchasers of such bonds feel they are bearing more risk. Having endorsed the principle of these clauses for the private sector, the Governments of the G-7 countries should set an example by including them in their own bonds.

G. More effective and equitable policy responses to financial crises

40. The adjustment programmes that accompanied the international financial assistance to crisis countries in 1997 and 1998 were subject to considerable criticism, including by the staff of IMF itself.[17] Among the lessons drawn from these reviews was the need to better tailor the requirements of adjustment to the situation being faced at that moment in each country. The severe contractions of the economies that followed the initial policy responses in each of the crisis countries in 1997-1998 underlined the fact that neither fiscal tightening nor a prolonged credit crunch is appropriate while an economy is collapsing under the pressure of a financial crisis. Sharp monetary tightening at the onset of a payments crisis might offer some benefits if it bolsters investor confidence and raises the attractiveness of domestic financial assets. However, such actions can also undermine confidence if they weaken a fragile financial system and leave the non-financial sector devoid of working capital. Consequently, it is now more widely recognized that changes should be considered as soon as it is realized that the policies being pursued are not having the expected effect.

41. Most of the adjustment programmes adopted by crisis countries in 1997-1998 embodied not only macroeconomic measures but also a wide range of structural reforms. A second conclusion from this experience is that the midst of a financial crisis is not the time to overload a country with a host of structural reform obligations, even if such measures are warranted for long-term development.

42. The heavy costs that recent crises have imposed on lower-income strata of the population in crisis countries and on the vulnerable more generally have focused attention on the social dimensions of adjustment. Recent efforts of the World Bank and regional development banks, the United Nations system, bilateral donors and non-governmental organizations have helped to ameliorate the adverse consequences of the crises and their aftermath. Nevertheless, this experience has demonstrated that comprehensive and effective national social safety nets need to be in place before a crisis strikes.

43. In this regard, the Development Committee of IMF and the World Bank, at its meeting in October 1998, called on the Bank to work with the United Nations, IMF and other partners to develop general principles of good practice in social policies. At its April 1999 meeting, the Development Committee decided that further work on these principles was best pursued within the framework of the United Nations. This matter is now under consideration by the

Preparatory Committee for the Special Session of the General Assembly on the Implementation of the Outcome of the World Summit for Social Development and Further Initiatives.

H. New institutional arrangements

44. The Asian financial crisis spurred the Governments of the major economies to consult with other countries as they sought to strengthen the international financial system. The United States convoked the "Group of 22" by inviting Finance Ministers and Central Bank Governors of 21 developed and emerging economy countries to join with it in early 1998 to consider reform issues. The Group established three working groups, which drafted reports on transparency and accountability in financial transactions, on strengthening financial systems, and on dealing with international financial crises, which were circulated in October 1998. The Group was then disbanded, but some of the ideas discussed in its reports were incorporated in a statement by the G-7 on 30 October 1998.

45. Subsequently, a new ad hoc grouping of 33 developed and emerging economy countries was formed. It met at the level of senior officials for two "seminars", one in March 1999 in Bonn and the other in April 1999 in Washington, D.C. At its June 1999 summit, the G-7 committed itself to establishing an "informal mechanism for dialogue among systemically important countries". The new mechanism, currently known as Group X, was seen by the G-7 as falling "within the framework of the Bretton Woods institutional system" (para. 7A of June 1999 Summit communiqué), leaving open the question of how the mechanism would relate to the Interim Committee or the multilateral system as a whole.

46. The international community has also strengthened collaboration between international institutions, in particular IMF and the World Bank, while respecting their distinct mandates. In addition to cooperating in their programmes in crisis countries, the Fund and the Bank established the Financial Sector Liaison Committee in September 1998 in order to enhance their collaboration in strengthening financial systems. In addition, following the assessment of IMF's Enhanced Structural Adjustment Facility (ESAF) in 1998, the Fund and the Bank pledged to intensify their collaboration in assisting the low-income countries that are the focus of ESAF programmes.[18] They subsequently collaborated in the 1999 review of the HIPC Initiative and will cooperate in assisting beneficiaries of the strengthened Initiative to prepare a poverty reduction strategy paper and to implement the corresponding policies.

47. Intergovernmental discussion across other institutional lines has also burgeoned. It has included the exchanges of visits of the Executive Boards of the Fund and the World Bank with the Economic and Social Council of the United Nations, and the high-level meetings of the Council with the Bretton Woods institutions in 1998 and 1999.

IV. Some avenues for further action

48. As noted in section II, there has been some return of financial flows to emerging markets and a recovery in stock market prices. Some, albeit not all, developing countries are again able to arrange medium-term international lending, but the terms are more stringent than before the crisis began. The excessively risky exposures of many market players have been reduced (although comprehensive information is lacking about the amount of their borrowing and whether it is once again growing). Many countries have implemented policy changes, but there remains considerable scope for further domestic measures to modernize and strengthen domestic financial sectors with a view to improving the mobilization of

domestic and foreign financial resources and to channelling them more effectively into productive investment.[19]

49. Despite the several initiatives of the international community identified in the preceding section, the reform of the "international financial architecture" remains an urgent piece of unfinished business. There are several opportunities for international discussion of such issues in the next few months, including the present session of the General Assembly and the tenth session of the United Nations Conference on Trade and Development (UNCTAD) in February 2000. The present section identifies some of the areas where further action might be taken.[20]

A. Attuning financial regulations to financial systems

50. Financial systems in developing and transition countries are, on the whole, more fragile than the global average. This suggests that, if they are to reduce the possibility of crises, financial regulations in these economies need to be more stringent than global standards. In particular, it could be argued that the Core Principles for Effective Banking Supervision should be strengthened when applied to emerging market economies and that capital-adequacy requirements should be higher than the global norms of the Basle Committee on Banking Supervision. With regard to the latter, one refinement could be to raise capital requirements temporarily in the face of mounting foreign euphoria about an economy, so as to discourage local banks from accepting new and potentially volatile funds. In addition, there should be international standards to combat money and asset laundering, corruption and tax evasion. With regard to the different types of financial intermediaries, there could be consolidated supervision of banks and non-bank financial sectors and the establishment of a set of "core principles" for consolidated supervision that would parallel those for banking supervision. All such standards should be consistent, *inter alia*, with the international human rights instruments of the United Nations, particularly the International Covenant on Economic, Social and Cultural Rights.[21]

51. Under the June 1999 Basle Committee proposals (see para. 30 above), the capital backing required for sovereign loans could depend in part on the ratings of private sector risk-rating agencies. However, subjective elements in the risk assessments by these agencies may aggravate swings in market perceptions. It is therefore important to foster greater transparency in sovereign risk ratings. In particular, they should be determined by strict, objective parameters that are publicly known.

52. The increasingly global character of financial markets and growing links between different categories of financial business have given rise to proposals for the creation of a global agency for financial regulation and supervision.[22] It is argued that, since financial businesses are becoming increasingly interrelated and cross-border, their regulation and supervision should also be carried out on a unified and global basis. The Financial Stability Forum is performing some of the functions that have been proposed for a new agency, and that body may evolve further. However, in an increasingly financially integrated world, any such international mechanism should embrace not only those countries that are already leading players in world financial markets, but also those wishing (and being encouraged) to join those markets. Recent events have highlighted the need to ensure that the financial systems in such countries are sufficiently resilient before, rather than after, their integration into world markets. The use of regional and subregional structures within such an arrangement could make it more effective and more responsive to the needs of developing and transition economies, and could provide a mechanism for peer review of national regulatory authorities and their implementation of internationally agreed standards.

53. Even with improved prudential regulation, there will always be limits to official regulatory systems, in part because of continuous financial innovation. Regulations should therefore continue to give weight to the strengthening of internal controls and risk management by financial institutions themselves.

B. Confronting international financial volatility

54. Even countries with strong economic and financial fundamentals and sound regulatory systems may be threatened by the volatility of international financial flows, notably short-run flows. Various fiscal, financial and administrative mechanisms are available for oversight and control of the capital account, depending on national circumstances. The primary objective is to reduce the destabilizing effects of short-term flows without disrupting long-term flows that contribute to development. In particular, modulating the pace of inflows, particularly short-term inflows, during a boom can reduce the scope for sudden and large outflows during a period of stress. In this context, market-related controls on capital inflows, such as those used by Chile for many years, have received broad support. Given the persistence of international volatility and widespread domestic financial fragility, such mechanisms should be recognized as possible options for managing international capital flows in the interest of development.

55. There is a wide range of views about the most appropriate exchange-rate arrangements — whether permanently fixed arrangements (such as a currency board), freely floating arrangements or any of the intermediate arrangements — and the most appropriate vary from country to country and over time. A great variety of exchange-rate regimes can be successfully managed in the current world economy, assuming that monetary, fiscal and reserves policies are kept consistent with the regime and that a country has the technical human resources to operate the chosen system. Governments should not, therefore, be pressed to adopt any particular form of exchange-rate regime.

C. Meeting the need for international financing during crises

56. The amount of public financing needed for international rescue financial packages depends in part on the contribution of the private sector. The approach to bailing in private creditors has aimed at facilitating "voluntary" renegotiation of debt instruments. A more inclusive approach would establish conditions and procedures for a general "standstill" on external financial transactions. The standstill would entail an internationally endorsed suspension of capital-account convertibility. In addition to halting capital flight, this would provide a breathing space during which domestic official and private borrowers could be brought together with foreign lenders to reschedule foreign debt. The conditions attached to IMF lending into arrears, including cooperation with the Fund to correct the sources of the balance-of-payments problem, would have to be satisfied. In addition, the international community could set a time limit for completing negotiations regarding the rescheduling of foreign debt, after which restructuring could be decided by an arbitration process. This more comprehensive approach to debt rescheduling should reduce the possibility of "free riders".

57. The IMF's Compensatory and Contingency Financing Facility (CCFF) lends to member countries that are experiencing a temporary shortfall in export earnings resulting from a decline in international commodity prices, a surge in food-import costs or other specified emergencies. As originally conceived, CCFF was known as a "low conditionality"

facility because it did not require negotiation of a full adjustment programme, as under a standard standby arrangement. CCFF was intended to supply funds quickly to help meet a special need for external financing arising from some untoward and temporary development beyond the control of the country. Nowadays, this facility is used mainly in funding IMF-supported adjustment programmes. However, the reasons for creating CCFF remain valid. As part of the broader effort to increase the availability of emergency financing, it could be used more actively and larger drawings could be accessible through it.

58. CCFF is not aimed, however, at dealing with instability coming from international capital flows, for which a mechanism such as CCL would be more appropriate. To be effective, such a mechanism should have a high degree of automaticity and should not be subject to complex conditions and lengthy approval processes. However, it also needs to command large resources (so that it can be available to a number of countries simultaneously in the event of contagion).

59. A CCL-type arrangement may be seen as an international analogue to the "lender of last resort" function that a central bank can play for its domestic commercial banking sector. A central bank, because it serves as the monetary authority of a country, has virtually unlimited power to lend in domestic currency to the commercial banks. IMF does not have such power at the global level because it does not issue money and is not permitted to borrow from financial markets. However, it can create international liquidity through the issuance of special drawing rights (SDRs). In order to meet the need for a rapid increase in the supply of international liquidity in times of crisis, consideration should be given to allowing the Fund to issue SDRs to itself, as needed, for use in lending to countries facing financial crises. After the crisis ended, the SDRs would be retired as they were repaid.

60. Drawing on the success of monetary cooperation in the European Union and more limited efforts in other regional groupings, regional and subregional organizations could be given a larger role in the global financial architecture. For example, regional reserve funds could supplement IMF funds in times of difficulty. Such regional funds could be given access to the counter-cyclical allocations of SDRs proposed above. Furthermore, regional peer review could play an effective role in macroeconomic surveillance and in the oversight of domestic financial regulation and supervision. Regional organizations might offer a more appropriate set of partners for such peer reviews than those drawn from a global pool.

D. Focusing the content of adjustment programmes

61. While greater sensitization of the international community to social and development aspects of adjustment is welcomed, there is concern about the scope of the policy measures that are included in balance-of-payments adjustment programmes supported by IMF. Governments in the midst of a balance-of-payments crisis should not be pressured to reach decisions that pertain to other matters, that are normally made elsewhere and that are better decided under different conditions. In particular, it is felt that IMF conditionality should not extend to issues related to economic and social development strategies and institutions, nor to political and governance issues. Similarly, it should not embrace matters within the purview of other international institutions, such as the World Trade Organization and the International Labour Organization.

E. Democratizing governance of the international financial system

62. International discussions of the world economic situation take place in various official forums, but the opportunities for most Governments to participate in discussions that influence policy makers from the major economy countries are limited. In September 1999, members of IMF decided to upgrade the Interim Committee to a permanent body of IMF, to be called the International Monetary and Financial Committee (IMFC). This Committee will retain the present constituency structure, with the addition of the President of the Financial Stability Forum. However, the representation of the developing and transition economies — the borrowers from IMF — will continue to be limited.

63. As indicated in the preceding section, a number of other new arrangements for consultation on various international monetary and financial issues among so-called systemically significant economies have been made, including the former Group of 22, the Financial Stability Forum and, most recently, the Group X (G-X). The creation of these new bodies reflects a recognition that the multilateral financial system had lacunae, but these bodies are not an integral part of the multilateral trade and financial system and it is not yet clear that they adequately fill such lacunae. Moreover, even though developing and transition economies have been — and continue to be — the most adversely affected by the global financial crisis, they are not commensurately reflected in the membership of these mechanisms, even though one of them has the specific aim of "promot(ing) cooperation to achieve stable and sustainable world economic growth that benefits all".[23] Ways need to be found to introduce gre .er pluralism into the governance of the international financial system so that it reflects the diversity among economies, their levels of development and their goals.

Notes

[1] The report of this meeting is being made available to the General Assembly by the Government of Mexico (see A/54/384, annex, appendix).

[2] The data and analysis in this section are drawn largely from *World Economic and Social Survey, 1999* (United Nations publication, Sales No. E.99.II.C.1). For a review in a longer-term context, see *Trade and Development Report, 1999* (United Nations publication, Sales No. E.99.II.D.1), part two, chap. V.

[3] See Ricardo Ffrench-Davis and Stephany Griffith-Jones, eds., *Coping with Capital Surges: The Return of Finance to Latin America* (Boulder, Colorado, Lynne Rienner, 1995).

[4] While they were not grouped with the developing countries in table 1, there was also a significant contraction in private lending to the economies in transition, particularly after the Russian crisis began in August 1998.

[5] The public sector borrowing requirement in Brazil rose from 8 per cent of the gross domestic product (GDP) in December 1998 to about 14 per cent of GDP in February 1999 (see *World Economic and Social Survey, 1999...*, chap. III, subsect. entitled "Latin America and the Caribbean: the Brazilian currency crisis and financial contagion").

[6] The preliminary estimates noted in this paragraph were issued by the United Nations Conference on Trade and Development (UNCTAD) in a series of press releases between April and July 1999. Final data and a more detailed analysis are contained in *World Investment Report, 1999: Foreign Direct Investment and the Challenge of Development* (United Nations publication, Sales No. E.99.11.D.3).

[7] See *World Economic and Social Survey, 1999...*, tables A.19, A.20 and A.23.

[8] See OECD news release, Paris, 10 June 1999.

[9] For additional information, see the Report of the Secretary-General on the debt situation in the developing countries (A/54/370).

[10] The principles involved are discussed in *World Economic and Social Survey, 1999* ..., box V.1, entitled "Bank safety tool kits and moral hazard". The issues discussed therein apply equally to developed economies, as illustrated by the Japanese banking crisis (ibid., chap. V, sect. entitled "The nature of banking in developed economies: strength into weakness: banking in Japan").

[11] Countries undertaking IMF-supported adjustment programmes are also agreeing to publication of their "Letters of Intent" and similar documents.

[12] Available on the Web (at www.imf.org/external/np/fad/trans/index.htm).

[13] See report of the Secretary-General on global financial integration: an update (A/52/406), paras. 26-44; and, for more recent developments, BIS, *69th Annual Report* (Basle, 7 June 1999), pp. 152-157.

[14] For additional information, see Hans Tietmeyer, "Evolving cooperation and coordination in financial market surveillance", *Finance and Development*, September 1999, pp. 20-23.

[15] See *World Economic and Social Survey 1999* ..., chap. IX, sect. entitled "'High-tech' international finance".

[16] American-style bonds require the unanimous consent of bondholders to change the terms of the bond; this contrasts with the majorities that would be specified in collective action clauses. In addition, American-style bonds do not have a sharing clause, as in bank loan syndications, wherein any member of the syndicate that receives a payment when the debt is not fully serviced is required to share that payment with the other members of the syndicate. As a result, holders of American-style bonds by default have no incentive to cooperate with other creditors in restructuring the borrower's debt and may instead seek redress through the courts.

[17] See Timothy D. Lane and others, *IMF-Supported Programmes in Indonesia, Korea and Thailand: A Preliminary Assessment*, Occasional Paper, No. 178 (Washington, D.C., IMF, 1999).

[18] See IMF, *Annual Report, 1999* (Washington, D.C., 1999), chap. 8, pp. 89-90; and appendix IV, p. 176.

[19] For an examination of possible policy actions in this area, see *World Economic and Social Survey 1999* ..., part two.

[20] The present section draws on the report of the Executive Committee on Economic and Social Affairs entitled "Towards a new international financial architecture", available on the United Nations Web page (www.un.org/esa/coordination/ifa.htm).

[21] See General Assembly resolution 2200 A (XXI), annex.

[22] For example, the former Committee for Development Planning (now the Committee for Development Policy) at its thirty-first and thirty-second sessions proposed the creation of a "world financial organization" to give overall guidance to the various international regulatory mechanisms. (See *Official Records of the Economic and Social Council, 1997, Supplement No. 15* (E/1997/35), paras. 208-210; and ibid., *1998, Supplement No. 14*, (E/1998/34), paras. 63-65).

[23] Statement of G-7 Finance Ministers and Central Bank Governors, 25 September 1999, para. 19.